Accounting Historians Journal

Volume 15
Issue 1 *Spring 1988*

Article 4

1988

Evolution of the unitary tax apportionment method

Nancy Foran

Dahli Gray

The Accounting Historians Journal
Vol. 15, No. 1
Spring 1988

Nancy Foran
THE WICHITA STATE UNIVERSITY
and
Dahli Gray
Peat Marwick Research Fellow
UNIVERSITY OF NOTRE DAME

THE EVOLUTION OF THE UNITARY TAX APPORTIONMENT METHOD

Abstract: Taxpayers and taxing jurisdictions are, by definition and motivation, opposing forces and, therefore, in continual conflict. Taxpayers strive to minimize their tax liabilities while taxing jurisdictions seek ways to maximize their tax revenues. The unitary tax apportionment method was conceived by taxing jurisdictions as a method to prevent taxpayers from avoiding their fair share of the tax burden. The method evolved from a fairly insignificant procedure for the assessment of local property taxes to a very controversial means of apportioning the worldwide income of multinational corporate groups. Taxpayers have challenged the unitary tax apportionment method by utilizing economic sanctions, the legal system and the political process.

This paper traces the effect of taxpayers' judicial, political and economic actions on the evolution of the unitary tax apportionment method. The study demonstrates that although taxpayers challenged this expansion numerous times in the courts and through the political process, it was not until taxpayers used economic sanctions that the states began to restrict the reach of the unitary method.

Public law, case law, position statements, interviews and journal and newspaper articles provided the data for this study.

INTRODUCTION

When a business has operations within one tax jurisdiction, the resources and activities of that business are subject to tax only in that jurisdiction. However, when a business has operations in more than one tax jurisdiction, it is necessary to determine and tax the income and property values attributable to each jurisdiction in which the business operates. Three methods may be used in this determination: separate accounting, formula apportionment and specific allocation. The method used depends on the nature of the taxpayer's business and the laws of the tax jurisdiction.

If the business activity within a tax jurisdiction is not connected with the business activity outside the jurisdiction, separate accounting is the appropriate method for dividing the

tax base. Separate accounting divides the operations and resources of a multi-jurisdictional business into geographically separate units to segregate the within-jurisdictional activities from those arising elsewhere. Those activities are then treated as separate entities and are accounted for and subject to tax independently. Because this method does not recognize the "contributions to income resulting from functional integration, centralization of management and economies of scale" [*Mobil Oil Corp.*, 445 US 425], this segregation of income and property is clear and accurate only if the business within the jurisdiction actually is, in fact, separate and distinct from that outside the jurisdiction.

If the business activity within a tax jurisdiction is connected with the business activity outside the jurisdiction, the entire business is considered to be a single unit whose resources and activities within the jurisdiction are an inseparable part of a business that is carried on in several jurisdictions and contribute to the overall tax base. Therefore, it is necessary to consider the resources and operations of the entire business unit, of which the within-jurisdictional activities are a part, to determine the tax base attributable to each tax jurisdiction. This is accomplished by (1) combining the resources and/or activities of the entire business, regardless of geographic location, to determine the combined tax base; (2) calculating the apportionment ratio based on the required factor formula; and (3) applying the appropriate apportionment ratio to the combined tax base. Tangible property, intangible property, capital stock, gross receipts and net income have been used as the tax base. The factors utilized to calculate the apportionment ratio have included tangible and intangible property, payroll, sales, manufacturing costs, inventory, expenditure and net cost of sales. The apportionment ratio is a percentage, the numerator of which is the value of the factor attributable to the taxpayer in the taxing jurisdiction and the denominator of which is the value of the factor attributable to the taxpayer everywhere. The calculation of the apportionment ratio must consider the extent of the apportionment. Taxing jurisdictions may include in the denominator the value of the factors attributable to the taxpayer worldwide, while others may limit the factors to those arising only within the United States. Thus, the formula apportionment method recognizes that the resources and income-producing activities of an integrated, interdependent business cannot be isolated.

When the tax base can be directly traced to a particular tax jurisdiction and is not related to overall business operations, specific allocation may be used. This method attributes certain resources and activities, in their entirety, to the tax jurisdictions in which they are located. Specific allocation is often applied to real and personal property, patents and copyrights and to the income that is generated from these items.

THE ORIGIN OF THE UNITARY METHOD 1800-1899

In the 1800s, local governments levied taxes on property located within their jurisdictions. As businesses expanded their operations across city, county and state lines, it became difficult for each tax jurisdiction to determine its fair share of the entity's property value subject to tax. The use of apportionment can be traced to New Hampshire when, in 1842, that state enacted a law which assigned the responsibility of administering the assessment of railroad property to a state board. The board then apportioned the resulting tax revenue

Table 1

The Evolution of Unitary Apportionment
1842 to 1988

Year	State Action	Property Base	Scope	Apportionment Factors
1842	New Hampshire State Law	PROPERTY	INTRASTATE (local:state)	PROPERTY
1868	Pennsylvania State Law			
1911	Wisconsin State Law	INCOME	INTERSTATE (state:U.S.)	MULTIPLE FACTORS
1917	New York State Law		WORLDWIDE (state:worldwide)	
1936	General Power of California Tax Commissioner (Combined Report)		WORLDWIDE MULTICORPORATE GROUPS	
1988	Florida State Law (Subsequently Repealed)	SALES & USE		

among the state and the localities [Runke and Fender, 1977, p. 26]. The use of apportionment prevented firms from manipulating their asset values in such a way that higher values would be reported in jurisdictions with low tax rates.

The Pennsylvania Statute of May 1, 1868, applied the apportionment concept to the tax base of an entire firm. In doing so, Pennsylvania included the firm's out-of-state assets and activities in the apportionable base. The statute levied a tax on the capital stock of all corporations doing business in Pennsylvania. The assessment on railroads was based on the ratio of the corporation's in-state railroad track mileage to its mileage in all states. The act also imposed a gross receipts tax which was computed by apportioning the gross receipts of a company based upon the proportion of track mileage within the state [88 US 492]. Thus, the unitary method expanded from an *intra*state method to include *inter*state commerce.

Interstate apportionment was soon adopted by other states. On March 4, 1869, the State of Kansas approved a measure which provided for the assessment of railroad property by a board of county clerks. The assessment included all of the property owned by the railroad, including that which was located in other states. The assessment was apportioned between the states and then among the Kansas counties and cities through which the railroad ran based upon the proportion of the property's value within each county. The rolling stock was apportioned according to the track mileage within the county [136 Kansas Reports 210].

On April 8, 1869, the State of Delaware levied a tax on the capital stock and on the net profits of all railroad or canal companies incorporated in Delaware and doing business within the state. The earnings and capital stock subject to the tax were apportioned according to the proportion of the length of the road or canal within the state [85 US 206].

The Kansas apportionment formula for the assessment of taxes was challenged and upheld in the 1871 case of *Missouri River, F.S. & G.R. Co.* [136 Kansas Reports 210]. The Kansas Supreme Court ruled that:

> A railroad is an entire thing and should be assessed as a whole . . . A portion of a railroad, running through one township only, would be worth but little if anything, while that same portion, in connection with the balance of the road, might be invaluable. The legislature have wisely provided that each road shall be assessed as a whole, and then that assess-

> ment shall be apportioned for taxation to each county, township, etc., through which the road runs.

The decision distinguished the *taxation* of out-of-state property from the *use* of out-of-state property to value the property within the state:

> . . . but the assessment of property out of the state or out of the taxing districts is not made for the purpose of taxing said property, but only for the purpose of ascertaining the value of the property within the state and within the taxing districts . . . a railroad is an entire thing, and cannot be valued or assessed except as a whole.

The states continued to adopt the apportionment method. On March 30, 1872, the State of Illinois assessed a tax on the capital stock and franchise of railroads based on the proportion of track mileage within each county or city [92 US 575].

Corporations, however, continued to resist the reach of apportionment by challenging, in court, the apportionment method. In the 1874 *Delaware Railroad Tax* [85 US 206] case, the taxpayer argued that the apportionment method imposes taxes upon property beyond the jurisdiction of the state and conflicts with the power of Congress to regulate commerce. The United States Supreme Court, however, approved the method of apportionment and ruled that a tax proportioned according to track mileage was a tax on the corporation itself; it was not a tax on the stockholders or on the property of the corporation.

The Supreme Court also upheld the Commonwealth of Pennsylvania's right to use the apportionment method in the 1875 *Erie Railway Company* [88 US 492] case. The Court ruled that the state had the power to impose the tax and that the extent and proportion to which it was imposed belonged to the judgment and discretion of the state.

The railroad companies also unsuccessfully challenged the Illinois statute. They argued [*State Railroad Tax Cases,* 92 US 575] that distributing the assessed value of property without regard to its actual location was illegal. In this 1876 case, the Supreme Court affirmed the use of the apportionment method and established what has become known as the "unit rule":

> The theory of the system is manifestly to treat the railroad track, its rolling stock, its franchise and its capital, as a unit for taxation and to distribute the assessed value of this unit according as the length of

> the road in each county, city and town bears to the whole length of the road.

The original unit rule, which is also referred to as the unitary apportionment method, was based on the concept that, due to the physical connection of railroad property, the property value in each jurisdiction contributed to the value of the entire business:

> The track of the road is but one track, from one end of it to the other, and, except in its use as one track, is of little value . . . Destroy by any means a few miles of this track, within an interior county, so as to cut off the connection between the two parts thus separated, and, if it could not be repaired or replaced, its effect upon the value of the remainder of the road is out of all proportion to the mere local value of the part of it destroyed.

On April 27, 1893, the State of Ohio assessed a tax on the property of express companies in several states. Ignoring the location of the property among the states, Ohio's interstate property apportionment was based on the proportion of mileage of telegraph lines within the state relative to the firm's total telegraph mileage nationwide. This unitary method of apportionment was challenged, but upheld in the 1897 Supreme Court cases of *Adams Express Company, American Express Company,* and *The United States Express Company* [165 US 194, 166 US 185]. The Court established the principle that a business unit is determined by considering its use and management, rather than its physical location. When property is used in several states and it contributes to the firm as a whole, its value must be allocated among the states. The Court recognized that the property value subject to tax includes both tangible and intangible property and that the property value of a business unit subject to tax exceeds the sum of the values of its individual properties:

> . . . whenever separate articles of tangible property are joined together, not simply by a unity of ownership, but in a unity of use, there is not infrequently developed a property, intangible though it may be, which in value exceeds the aggregate of the value of the separate pieces of tangible property.

THE EXTENSION OF THE UNITARY METHOD TO INCOME 1900-1959

At the turn of the century, state expenditures began to increase as the states began to provide additional services to their constituents. Because property taxes were unpopular and difficult to administer, new sources of revenue were needed. Although several states imposed income taxes following the panic of 1837 and the Civil War, those taxes were also unpopular and difficult to administer. In 1911, Wisconsin enacted the first successful modern state income tax. This tax recognized the need to account for the income of unitary multijurisdictional corporations and allowed the use of separate accounting, specific allocation and formula apportionment. Thus, the unitary method evolved to include both an apportionment of property value and taxable income. The Wisconsin law provided for the apportionment of *income* based upon the value of *property*, sales and manufacturing costs within the state. Virginia (1915) and Missouri (1917) also imposed direct income taxes and provided for formula apportionment. Some states were unable to levy an income tax because of constitutional prohibitions against direct taxes. Therefore, states such as Montana (1917), New York (1917) and Massachusetts (1920), levied indirect taxes in the form of franchise or privilege taxes which were based on net income. New York and Massachusetts also provided for formula apportionment. Massachusetts used a three-factor formula based on property, payroll and sales [House Report No. 1480 on State Taxation, 1964]. The formula was based on the theory that the factors were a source of the taxpayer's income or a source of costs to the tax jurisdiction. Property was included as an apportionment factor, because it reflected the contribution of capital to the generation of income. In addition, the amount of property located in a jurisdiction determined the cost of the services, such as highways and fire and police protection, provided to the business by the local government. Similarly, payroll represented the income-producing value of employees and the cost of services such as schools, pollution control and welfare benefits provided by the government to the employees of the business. Sales were representative of income because they indicated the level of business activity within the jurisdiction [Hellerstein, 1983]. This three-factor formula is now the most widely used unitary method and is commonly referred to as the Massachusetts formula.

Underwood Typewriter Company [254 US 112] challenged the State of Connecticut's single-factor method of apportionment in 1920. The Supreme Court, however, supported the application of the unitary method for income tax purposes. It determined that the profit of the multi-jurisdiction business was earned by a single "series of transactions beginning with manufacture in Connecticut and ending with sale in other states" and was, therefore, subject to apportionment. The only limitation placed on the use of the unitary method was that the formula must not be inherently arbitrary or produce an unreasonable result.

The unitary method was then extended to vertically integrated businesses operating in the U.S. and foreign countries. In 1924, *Bass, Ratcliff and Gretton Limited* [266 US 271] argued that New York's worldwide unitary tax apportionment method (WUTAM) violated the internationally accepted taxation method of separate accounting and was unconstitutional. The Supreme Court ruled that the British corporation was a unitary business whose profits were earned by "a series of transactions beginning with the manufacture in England and ending in sales in New York." Therefore, worldwide business profits were deemed to be apportionable and such apportionment was not an unconstitutional burden on foreign commerce.

By the 1930s, the concept of the unitary method was well established; however, the apportionment formula was disputed. In 1931, the Supreme Court ruled that, based on the facts of the case, North Carolina's one-factor unitary allocation method, which produced a 250% spread between the income reported under the separate accounting method and the unitary method, was unreasonable [*Hans Rees' Sons, Incorporated,* 283 US 123].

In 1936, California instituted the concept of the combined report. The combined report was not based on a specific California law, but was derived from the general power and duty of the Franchise Tax Commissioner to determine the income attributable to sources within the state [*Edison California Stores, Inc.,* 183 P.2d 16]. The purpose of the combined report was to prevent controlled corporations from manipulating intercompany transactions to avoid tax and to treat multi-corporate businesses as a unit in the computation and apportionment of their total income. Because multi-corporate unitary groups were treated as a single corporation whose total multi-jurisdictional income was subject to apportionment, the combined report eliminated the potential for tax avoidance by

the establishment of different corporations in different states. The combined report differed from a consolidated return in that the combined report was an information return, not a tax return [Keesling, 1975].

In 1936, the State of California applied the three-factor unitary method of apportionment to an Illinois corporation with several divisions, one of which was located in California, in accordance with California law. This law stated:

> . . . if the entire business . . . is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll [sic], value and situs of tangible property . . . [General Laws, Act 8488, Vol. 2, p. 3858, Stats. 1929, pp. 19, 24, amended by Stats. 1931, p. 2226, Stats. 1935, p. 965]

California argued that the activities of the corporations within the state were not separate and distinct from those outside the state, and therefore, the use of the unitary method was appropriate. The California Supreme Court [*Butler Bros.*, 111 P.2d 334, 1941] agreed with the State's position:

> It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer.

The decision of the court established a three-prong test which is now widely used to identify a unitary business and which supported the finding of a unitary business in this case:

1) unity of ownership;
2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and
3) unity of use in its centralized executive force and general system of operations.

On appeal in 1942, the U.S. Supreme Court [*Butler Bros.*, 315 US 501] supported the California Supreme Court's finding of a unitary business, stating; "There is unity of ownership and management. And the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated." Further, "we cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula."

The expansion of the reach of the unitary method from single corporations with multiple divisions to multiple corporations was supported by the California Supreme Court in the case of *Edison California Stores* [183 P.2d 16] in 1938. Edison consisted of a Delaware corporation and fifteen wholly owned subsidiary corporations, each of whom operated only within a particular state. California treated the parent and its subsidiaries as a single unitary business and applied three-factor apportionment to the combined income. The California Supreme Court established that the unitary method could be applied because the elements of a unitary business (unity of ownership, operation and use) were present. The organization of a unitary business as separate corporations would not defeat the taxation of a business as a unit. The court also established an additional test (the dependency test) to support the finding of a unitary business:

> If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate.

In addition, the court determined that the power to assert the unitary method emanates from the authority of the state tax commissioner to compute net income in accordance with a method that clearly reflects income, rather than from an authority to require consolidated returns.

In the 1950s, states began to apply the unitary method to interstate income of corporations incorporated outside of a state in which the firm engaged in very limited activities. In 1959, the Supreme Court supported this expansion of the unitary method in three cases. In the case of *Northwestern Portland Cement Co.* [358 US 450], the Court ruled that the state could apportion income even when the firm only solicited sales orders and maintained local sales offices. In the case of *Brown-Forman Distillers Corp.* [359 US 28], the Court ruled that the

state could apportion income when representatives called on wholesalers but did not solicit orders. Finally, in the case of *ET & WNC Transportation* [359 US 28], the Court ruled that an interstate motor carrier was liable for income tax in the states it served.

Despite taxpayers' efforts to limit the scope of the unitary method by judicial means, the courts continued to support the tax authorities in their broad interpretation of the method. During the years from 1870 to 1959 (Table 1), the unitary method expanded significantly. In 1842, the unitary method was used as a method of determining the property tax of *intra*state businesses based upon their share of property value. By 1959, the unitary method was used to determine the income tax of multinational corporate groups based upon their proportionate share of worldwide payroll, sales and property even though only limited business activities occurred within a particular tax jurisdiction.

THE EFFECT OF POLITICAL AND JUDICIAL ACTION ON THE UNITARY METHOD 1959-1983

Taxpayers strongly opposed the judicial decisions that supported the expansion of the unitary method and they exerted pressure on Congress to enact legislation limiting the scope of the unitary method. In response to this pressure, Congress passed Public Law 86-272 in 1959. This law prevented states from imposing a net income tax on a business if the only activity of the business in the state was the solicitation of orders or the delivery of goods to customers when the delivery of orders was filled from outside the state. The law did not apply to service and financial companies.

Public Law 86-272 also directed the House Judiciary Committee and the Senate Finance Committee to study state taxation of interstate commerce and to propose appropriate federal legislation. A report was published in 1964 and 1965 recommending that federal legislation be enacted to provide uniform standards, tax bases, rules for division of income among states and procedures for the administration of those rules.

The states, however, strongly resented and resisted the prospect of federal intervention in state tax matters. The report prompted seven states to enter into the Multistate Tax Compact in 1967. The Compact established the Multistate Tax Commission to improve state tax administration and to en-

Table 2

The Effect of Judicial and Political Actions on the Unitary Method
1959 to 1983

Year	Category	Action	Effect
1959	Political	Taxpayers Pressured Congress	Public Law 86-272
1959	Political	Passage of Public Law 86-272	Recommended Federal Legislation
1965	Political	Federal Legislation Recommended	Multistate Tax Compact Established
1975	Political	Tax Treaties Negotiated	U.K. Unsuccessfully Introduced "Water's Edge" Concept
1979	Political	Unitary Tax Campaign Formed	Lobbied against WUTAM
1983	Judicial	Container Case Decided	Supreme Court Ruled in Favor of the States
1983	Political	Foreign Governments Protested Container Decision	U.S. Filed Amicus Brief Supporting Rehearing & Federal Legislation
1983	Political	President Reagan Formed Unitary Taxation Working Group	Recommended Federal Legislation
1983	Judicial	Alcan Aluminum Case Decided	Courts Refused to Rule on Case U.S. filed Amicus Brief
1983	Judicial	Shell Petroleum Case Decided	Supreme Court Refused to Hear Appeal-10 European Countries Filed Amicus Brief

courage uniformity among state laws as they applied to multistate business. The Compact provided for arbitration among the states and multistate audit procedures. It endorsed the rules of the three-factor apportionment formula, with an optional computation for small taxpayers with limited activities within a state.

The governments of foreign countries began to protest the application of the unitary method to the worldwide income of multinational corporations. These governments argued that the WUTAM, as imposed by the states, was inconsistent with international agreements entered into by the U.S. government and had a negative effect on international relations.

In 1975, the U.S. was involved in income tax treaty negotiations with the United Kingdom (U.K.). For British-based companies operating in the U.S., the U.K. requested that income subject to apportionment in a state be limited to income earned within the United States. This concept is called the water's edge method. The provision was deleted from the treaty before it was ratified by the U.S. Senate in 1978. The

British Parliament ratified the treaty only after being assured that the unitary problem would be solved. Other countries also unsuccessfully requested such provisions in their U.S. income tax treaties. Some countries threatened postponement of treaty negotiations, because they were committed to the water's edge method and opposed the WUTAM [Brown, Leegstra & Looram, July 1985, pp. 36-41].

In 1979, the Unitary Tax Campaign (UTC), a lobbying group composed of U.K. multinational corporations (MNCs), formed to protest the WUTAM. The UTC and other British MNCs used the political process by working with the U.K. government to exert pressure on the U.S. government and the state governments to pass legislation prohibiting the use of the WUTAM [Interview with Andrew M. Smith of the UTC].

California's three-factor unitary method was opposed by U.S. MNCs. In 1983, *The Container Corporation of America* [103 S.Ct. 2933] asked the courts to declare the method unconstitutional. The U.S. Supreme Court affirmed the California law and stated that the Court would support state court decisions unless they were unreasonable. However, the decision had substantial political repercussions.

Several foreign governments protested the *Container* decision and asked President Ronald Reagan to order the Solicitor General to file an amicus curiae brief in support of a rehearing of this decision and to support federal legislation to abolish the WUTAM. They contended that the *Container* decision discouraged foreign commerce and would undermine foreign policy. The President did not order the brief to be filed, but asked the Cabinet Council on Economic Affairs to study the issue. The Council recommended that federal legislation be drafted to confine the income subject to tax by the states to that earned within the United States. President Reagan responded to this recommendation by forming the Worldwide Unitary Taxation Working Group to achieve voluntary compliance at the state level. The Working Group consisted of representatives of federal and state government, U.S. MNCs, the National Association of Tax Administrators and the Secretary of the Treasury. At the time the Working Group was established, 12 states had imposed the WUTAM (Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah).

The Working Group arrived at a consenus, with qualified endorsements, on three issues: (1) adoption of the water's edge concept for U.S. and foreign corporations, (2) increased federal

assistance to and cooperation with the states to provide taxpayer disclosure and compliance and (3) competitive balance for U.S. MNCs, foreign MNCs and domestic corporations. The Working Group did not arrive at a consensus recommendation for the taxation of dividends paid by foreign subsidiaries to U.S. parent corporations or for the taxation of 80/20 companies (U.S. MNCs who do more than 80% of their business abroad). The Secretary of the Treasury submitted his report and the separate views of the Working Group members to the President in 1984. The Secretary also recommended that federal legislation be enacted to resolve the issue if the states did not prohibit the use of the WUTAM by mid-1985 [Treasury Dept. Working Group Report, August 1984].

Although *Container* established that the WUTAM as applied to a domestic corporation was constitutional, the court did not specifically address the constitutionality of the WUTAM as applied to a foreign parent. Therefore, in 1983, Alcan Aluminum, Ltd., a Canadian company, challenged the constitutionality of California's WUTAM. Alcan claimed that the method resulted in a direct tax on its income rather than on the income of its subsidiary and that it had been injured as a shareholder of the subsidiary. The Justice Department filed an amicus curiae brief in support of Alcan, stating that the WUTAM violated the federal government's power to conduct foreign relations and the foreign commerce and supremacy clauses of the Constitution. Despite the U.S. Justice Department's support, the Federal District Court in New York [558 F. Supp. 624 (S.D. N.Y. 1983)], the Second Circuit Court of Appeals [No. 83-7236 (2d Cir. June 17, 1983)], the Seventh Circuit Court of Appeals [724 F. 2d 1294, 1299 (7th Circ. 1983)] and the Supreme Court [104 S. Ct. 1457 (1984)] refused to rule on the Alcan case.

Shell Petroleum, a Dutch firm, also challenged California's WUTAM. The Ninth Circuit Court of Appeals ruled that the tax did not injure Shell independently of the U.S. subsidiary and, therefore, Shell did not have the right to challenge the method. The Supreme Court refused to hear an appeal of this case, even though ten European countries with U.S. business investments of $61 billion filed an amicus brief in favor of Shell.

From 1959 to 1983, taxpayers used both judicial and political processes to challenge the unitary method (Table 2). However, these political and judicial actions resulted in only a few modifications in state law. Therefore, MNCs and foreign governments felt compelled to utilize other methods to encour-

age the states to withdraw their liberal interpretation of the unitary method.

ECONOMIC CHALLENGES TO THE EXPANSION OF THE UNITARY METHOD AND THEIR EFFECT 1983-1988

A key factor that influenced the states to voluntarily consider the enactment of the water's edge method was the loss and threat of loss of foreign economic investment. Foreign business usually invests in the U.S. by expanding existing facilities or by building new manufacturing sites that are selected on a competitive basis. U.S. communities actively encourage and invite economic development, because they believe it creates new jobs, reduces welfare and unemployment costs and increases property and income tax revenue. U.S. communities are sensitive to any factor which might discourage investment.

Thus, when 27 out of 28 companies raised the unitary issue during an Oregon trade mission to Japan, community leaders began to question the continued use of the WUTAM [Curry, April 28, 1984, p. 2]. In addition, a survey of 120 Japanese companies revealed that 92 would make multi-million dollar investments in California if the WUTAM was repealed [Bleiberg, August 20, 1984, pp. 10-11].

In 1983, Keidanren (Federation of Economic Organizations), a trade group consisting of 812 Japanese corporations and 110 associations, and CRISIS (Committee to Restore an Internationally Stable Investment System), a group of 14 of the largest MNCs in the European Economic Community, began to lobby to restrict unitary apportionment to the water's edge. These groups indicated that they would withhold economic investment in those states that imposed the WUTAM [Bleiberg, December 5, 1983, pp. 10-11]. This was followed by an announcement by Mitsubishi that it would locate a manufacturing facility generating $37.3 million in tax revenue over the following five years in South Carolina, rather than in Oregon, because of the WUTAM [Schuh, August 1, 1984, p. 10]. In addition, Wacker Siltronics and several other firms indicated that the WUTAM was the factor which caused them to locate proposed plants in neighboring non-WUTAM states. NEC stated that it would locate in Oregon only if the state dropped the WUTAM [Schuh, August 1, 1984, p. 10].

In Indiana, Sony Corp. delayed announcing a large economic investment in the state until the WUTAM was aban-

Table 3

Economic Challenges to the WUTAM & Their Effect

1983-1988

Year	Category	Action
1983	Challenge	27 Japanese firms questioned Oregon's use of the WUTAM.
	Challenge	92 Japanese firms revealed California investment plans if WUTAM was repealed.
	Challenge	812 Japanese corporations and 110 associations and 14 of the largest MNCs in the EEC threaten to withhold U.S. economic investment unless WUTAM is repealed.
1984	Challenge	Mitsubishi announced plan to locate in South Carolina, a non-WUTAM state.
	Challenge	Wacker Siltronics, NEC, Sony Corporation, Kyocera International, Alcan, IBM and others either reduced or threatened to reduce investment in WUTAM states.
	Effect	Oregon, Massachusetts and Florida abandoned the WUTAM and adopted a Water's Edge approach.
1985	Effect	Indiana and Colorado abandoned the WUTAM and adopted a Water's Edge approach.
	Challenge	British House of Commons voted to eliminate dividend tax credit for U.S. firms based in WUTAM states.
1986	Effect	Utah, Idaho and New Hampshire abandoned the WUTAM and adopted a Water's Edge approach.
	Effect	California voted to allow a Water's Edge election for Worldwide Unitary firms.
1987	Effect	North Dakota voted to allow a Water's Edge election for Worldwide Unitary Firms.
	Effect	Montana abandoned the WUTAM and adopted a Water's Edge approach.
	Challenge	Service industries threatened to boycott Florida.
1988	Effect	Florida abandoned a sales and use tax based on WUTAM.

WUTAM = Worldwide Unitary Tax Apportionment Method
MNCs = Multinational Corporations
EEC = European Economic Community

doned [Bleiberg, August 20, 1984, pp. 8-9].

Kyocera International shut down a major facility in California because it contended that the WUTAM caused its tax bill to exceed its earnings during the previous 10 years. Sony and Alcan also cited the WUTAM as the reason for not expanding their California facilities [Bleiberg, August 20, 1984, pp. 8-9].

In Florida, IBM cancelled a proposed expansion because of the effect of the WUTAM on its state tax liability [Kiesel, American Bar Association Journal, June 1984, pp. 38-39].

The MNCs argued that the WUTAM not only increased their state tax liability, but also increased their accounting costs. In some instances, they argued that the cost of gathering the data to comply with the WUTAM was often greater than the tax itself. MNCs must restate and translate foreign finan-

cial and tax accounting reports into a format required by the state. Foreign MNCs often refused to furnish information on their foreign operations, arguing that to do so would violate other countries' secrecy laws. When such information was not available, states often computed the state tax with available public information [Brown, Leegstra & Looram, July 1985, pp. 36-41].

In California, over 90 U.S. MNCs formed the California Business Council asserting that abandonment of the WUTAM would benefit foreign corporations at the expense of U.S. firms. The American firms proposed that dividends from foreign subsidiaries not be taxed [Tanzer, 1985].

The threat of losing foreign investment was effective. In 1984, Florida and Oregon abandoned the WUTAM. Oregon adopted a water's edge method for foreign MNCs and required that a portion of the foreign dividend income received by U.S. MNCs be included in income. Within 18 months after Oregon dropped the WUTAM, eight Japanese firms located manufacturing or distribution facilities in Portland [Rooks, *Oregonian*, September 6, 1985, p. 83].

In the 1984 case of *Polaroid Corp.* [393 Mass. 490], the Massachusetts Supreme Judicial Court ruled that the Commissioner of Revenue lacked statutory authority to use the WUTAM. This decision prevented Massachusetts from assessing a state income tax based upon worldwide unitary apportionment.

To pressure states to adopt a water's edge approach, the British House of Commons approved a measure in 1985 [1985 U.K. Finance Bill, Section 54] to eliminate the tax credit of American companies for dividends paid to them by U.K. subsidiaries. The measure was to be effective as of April 1, 1985 and would have applied to companies that had 7½% or more of their property, payroll or sales in a WUTAM state, were subject to state income tax in a WUTAM state, and whose principal place of business was in a WUTAM state.

In response to this measure, President Reagan announced his support of federal legislation to prohibit the WUTAM. This announcement prompted Britain to agree to defer enactment of penalties against firms operating in both the U.K. and the WUTAM states if the federal legislation was introduced before the end of 1985 and was enacted before the end of 1986 [HM Government Statement]. Senator Baucus (D-Mont.) then proposed a retaliatory bill which would double the U.S. withholding tax on dividends paid to U.K. firms [Schmedel, Nov. 13,

1985, p. 1]. The British Government stated that it would not implement penalties against U.S. corporations in unitary states before December 31, 1988, unless it gave notice to the contrary [Parliamentary Proceedings, December 18, 1986].

Canada, Germany, Belgium, Italy, Switzerland, Japan and the Netherlands also threatened to retaliate unless the unitary method was restricted to the U.S.

Increased international economic pressure prompted the U.S. Treasury to release draft legislation opposing the WUTAM in mid-1985. The proposed law endorsed the water's edge method and increased taxpayer disclosure. President Reagan supported this legislation and authorized the Treasury Secretary to amend double taxation agreements. In addition, the President instructed the Attorney General to support the water's edge method in controversies and cases dealing with the WUTAM [Statement by the President, November 8, 1985]. The states, the National Governors Association and the National Conference of State Legislatures actively opposed this proposed legislation.

The Treasury's bill was introduced in the House of Representatives on December 18, 1985, as The Unitary Tax Bill of 1985 [House Bill 3980] and in the Senate as The Unitary Tax Repealer Act [Senate Bill 1974]. The proposed legislation excluded most foreign corporations and domestic 80/20 corporations from state taxation. However, foreign corporations which pay little or no foreign tax and have substantial dealings with U.S. corporations would be subject to the WUTAM. Also, the proposed law required that states tax only a portion of the dividends that U.S. companies receive from foreign corporations.

In addition, the proposed legislation required large and multinational corporations to file an annual information return with the Internal Revenue Service (IRS) that would detail their tax liability in each state. This domestic disclosure "spreadsheet" would be shared with the individual states and multistate audit agencies to provide assurance that corporations properly apportioned their income among the states. This proposed legislation was not acted upon prior to the end of the 99th Congress and, therefore, died in committee.

In 1985, Colorado and Indiana abandoned the WUTAM. Foreign firms responded to the legislative retreat to the water's edge method by increasing their investment in Indiana. Colorado, however, received no additional foreign investment. California, Alaska and Idaho considered, but did not approve,

the repeal of the WUTAM in 1985.

In March 1986, Utah revoked the WUTAM and instituted the water's edge method. In April 1986, Idaho enacted repealing legislation to be effective on January 1, 1988. New Hampshire abolished the WUTAM effective June 30, 1986, even though implementation rules were to be decided in December 1986.

In September 1986, California enacted Senate Bill 85 (effective January 1, 1988) which allows MNCs to elect to use the water's edge method and to partially exclude foreign source dividends. However, this election requires the payment of a fee based on the MNC's sales, tangible property and payroll in the state. In response to the California bill, the Reagan administration withdrew its support for those portions of the proposed federal legislation which would have prohibited the use of the WUTAM. The President continued to support those provisions which would require MNCs to file a domestic spreadsheet with the IRS and provide additional IRS audit support.

On April 21, 1987, North Dakota enacted legislation which would allow corporations to elect the water's edge method for taxable years beginning after December 31, 1988. The election is to be binding for ten consecutive years and requires that a domestic disclosure spreadsheet be filed. In addition, the election prevents the corporation from reducing taxable income by any Federal income tax paid.

A new application of the WUTAM was conceived by Florida in 1987. Effective July 1, 1987, Florida enacted a far-reaching sales and use tax which was imposed on services used or consumed in the state. The tax was computed by applying a three-factor (property, payroll and sales) apportionment formula on a worldwide basis to the cost of a service. It applied to "affiliated" groups, which were similar in nature to unitary groups, on a worldwide basis. The service sector of the economy, led by broadcasters, publishers and advertisers, strongly protested the tax. They launched a strong anti-tax advertising campaign and cancelled service-related programs and conventions. The protest was effective. The Florida Legislature repealed the tax as of January 1, 1988, six months after it became effective.

Despite the widespread voluntary adoption of the water's edge approach by the states, foreign governments and MNCs continued to press for federal legislation. On July 15, 1987, Representative Frenzel introduced the Domestic Corporation Taxation Equality Act of 1987 [House Bill 2940] in the House of

Representatives. The proposed legislation would prohibit states from using the worldwide unitary method unless the taxpayer would so elect. In addition, the legislation would not allow states to tax more than an "equitable portion" of any dividend received by a corporation. Identical legislation was introduced into the Senate by Senators Roth and Fowler on November 4, 1987, as Senate Bill 1843. The legislation has been referred to the House Ways and Means Committee and the Senate Finance Committee.

Montana, one of only two remaining WUTAM states, retreated to the water's edge on October 1, 1987, effective for taxable years beginning on or after January 1, 1988.

As of February 1988, Alaska was the only state not to enact legislation prohibiting the mandatory use of the WUTAM.

The ramifications of economic and political pressure were significant. Increased involvement in the issue by the leaders of foreign powers affected political alliances. Potential loss of state revenue threatened the states' economies. Economic sanctions disturbed harmony among the states. Political pressure and potential federal legislation altered the relationship between the federal and state governments. These pressures forced the states to reexamine their commitment to the WUTAM. Within three years, eleven states retreated to the water's edge method. Thus, the expansion of the unitary method was halted.

Table 3 summarizes the economic challenges to the unitary method and the states' responses to those challenges for the period 1983 to 1988.

CONCLUSION

This paper examined the conflict between taxpayers and tax jurisdictions and the effect of judicial interpretations, political pressures and economic behavior on tax policy by tracing the historical development of the unitary method of taxation from 1842 to 1988 (Table 4). Within a span of 146 years, the unitary method evolved from a method of assessing local property taxes to a means of apportioning the worldwide income of multinational corporate groups. The expansion of the method resulted from the tax jurisdictions' need for additional sources of revenue and from the geographic expansion and internationalization of business entities. Although taxpayers challenged this expansion numerous times in the courts, the judicial system supported the liberal interpretation of the method. Taxpayers used political pressure and economic sanctions to successfully force the states to abolish the WUTAM and

Table 4

Historical Development of the Unitary Method of Taxation
1842 to 1988

Extent of Apportionment	INTERSTATE	WATER'S EDGE	WORLDWIDE
Period			
1842-1959		Tax Jurisdictions Seek to Maximize Tax Revenues By Expanding the Application of Unitary Apportionment →	← Taxpapers Strive to Minimize Tax Liabilities by Challenging Unitary Apportionment Through the Judicial System
1959-1983		Tax Jurisdictions Maintain Application of Unitary Apportionment →	← Taxpayers Challenge Unitary Apportionment Through the Judicial & Political System
1983-1988	Tax Jurisdictions Retreat to Water's Edge →		← Taxpayers Challenge Unitary Apportionment Through the Political and Economic System

to retreat to a water's edge method. Although it appears that the taxpayers' threats of economic sanctions had the most significant effect on restricting the use of the WUTAM, it is difficult to clearly separate the impact of economic and political actions, since the political pressure appears to be economically motivated.

The unitary method adapted to a changing environment by expanding and contracting in scope. As tax jurisdictions continue to deal with the issue of identifying the tax entity and the property and income subject to tax, they will continue to be faced with tax measurement problems. This paper provides future researchers with both a foundation and a methodology for analyzing tax policy development. This is needed for an academic understanding of policy development and for a historical appreciation of the role of taxpayers in the evolution of tax policy.

REFERENCES

Adams Express Company, American Express Company, and the United States Express Company. 165 US 194, 166 US 185.

Bass, Ratcliff and Bretton Limited. 266 US 271.

Bleiberg, Robert M. "Killing the Goose?" *Barron's.* December 5, 1983.

_____. "Corporate Tax Revolt." *Barron's.* August 20, 1984.

Brown, Robert D., Leegstra, Ruurd G. and Looram, Lloyd J. "Unitary Tax: At the Crossroads? — Part II." *The CPA Journal.* July, 1985.

Brown-Forman Distillers Corp. 359 US 28.

Butler Bros. 111 P.2d 334, 1941.

Butler Bros. 315 US 501.

Container Corporation of America, The. 103 S.Ct. 2933.

Curry, Bill. "Oregon in Middle of Nationwide Unitary Tax Debate." *The Sunday Oregonian.* Portland, Oregon, April 29, 1984.

Delaware Railroad Tax Cases. 85 US 206.

Department of the Treasury. "The Final Report of the Worldwide Unitary Taxation Working Group." Office of the Secretary. August, 1984.

ET & WNC Transportation. 359 US 28.

Edison California Stores, Inc. 183 P.2d 16.

Erie Railway Company. 88 US 492.

General Laws, Act 8488, Vol. 2, p. 3858. Stats. 1929, pp. 19, 24. Amended by Stats. 1931, p. 2226, Stats. 1935, p. 965.

HM Government Statement. 1985.

Hans Rees' Sons, Inc. 283 US 123.

Hellerstein, Jerome R. *State Taxation: Corporate Income & Franchise Taxes.* Warren, Gorham & Lamont. Boston, 1983.

House Committee on the Judiciary. "Report of the Special Subcommittee on State Taxation of Interstate Commerce." House of Representatives Report No. 1480. (Willis Committee Report.) 88th Congress, 2nd Session. 1964.

Keesling, Frank M. "The Combined Report & Uniformity in Allocation Practices." *Multi-State Tax Commission 7th Annual Report, Appendix G.* 1975.

Kiesel, Diane. "Tax Wars." *American Bar Association Journal.* June 1984.

Missouri River, F.S. & G.R. Co. 136 Kansas Reports 210.
Mobil Oil Corp. 445 US 425.
Northwestern Portland Cement Co. 358 US 450.
Parliamentary Proceedings. December 18, 1986.
Polaroid Corp. 393 Mass. 490.
Rooks, Judy. "Bradley Says California May Repeal Unitary Tax." *Oregonian.* Portland, Oregon, September 6, 1985.
Runke, James and Fender, Alan E. *State Taxation of Railroads and Tax Relief Programs.* The Council of State Governments. Kentucky, 1977.
Schmedel, Scott R. "Re-retaliation." *Wall Street Journal.* November 13, 1985.
Schuh, Scott D. "Oregon Votes to Abandon Unitary Tax In Victory for MNCs." *Wall Street Journal.* August 1, 1984.
Smith, Andrew M. Unitary Tax Campaign Administrator who was interviewed by the authors in London in 1986.
State Railroad Tax Cases. 92 US 575.
Statement by the President. November 8, 1985.
Tanzer, Andrew. "Deukmejian's Dilemma." *Forbes,* January 28, 1985, pp. 62-63.
Underwood Typewriter Company. 254 US 112.
U.K. Finance Bill, Section 54. 1985.